Case No. D30/90

Profits tax – rebate commissions – whether arising in or derived from Hong Kong.

Panel: William Turnbull (chairman), Benjamin Kwok Chi Bun and Francis Jerome Law.

Dates of hearing: 14 and 15 June 1990.
Date of decision: 5 September 1990.

The taxpayer was a company incorporated in Hong Kong which was carrying on business as an investment adviser. The taxpayer advised customers with regard to investments and managed the investments for the customers. In the course of management the taxpayer invested funds belonging to the customer overseas and was entitled to certain rebate commissions. The rebate commissions were assessed to profits tax as arising in or derived from Hong Kong. It was submitted by the taxpayer that the rebate commissions arose outside of Hong Kong and should not be subject to Hong Kong profits tax.

Held:

The rebate commissions did not arise in and did not derive from Hong Kong and should not be subject to Hong Kong tax.

Appeal allowed.

[Editor's note: The Commissioner of Inland Revenue has filed an appeal against this decision.]

Cases referred to:

Ogden Industries Pty Ltd v Lucas [1970] AC 113
Smidth v Greenwood [1921] 3 KB 583
Rhodesia Metals Ltd v Commissioner of Taxation [1940] AC 774
Commissioner of Income Taxes (NSW) v Hillsdon Watts 57 CLR 36
CIR v Hang Seng Bank Limited [1989] 2 HKLR 236
Commissioner of Taxation v Chunilal B Mehta [1938] All India Reports 521
CIR v The Hong Kong and Whampoa Dock Company Limited [1960] HKLR 166
CIR v International Wood Products Limited [1971] 1 HKTC 551
BR 18/73, IRBRD, vol 1, 118
CIR v Karsten Larssen & Co (HK) Ltd [1951] 1 HKTC 11
CIR v HK-TVB Inland Revenue Appeal No 9 of [1989]

Adela Au for the Commissioner of Inland Revenue.
Anthony G Rogers QC for the taxpayer.

Decision:

This is an appeal by a taxpayer carrying on business in Hong Kong against a determination by the Commissioner which decided that certain rebate commissions were chargeable to tax in Hong Kong in respect of the years of assessment 1985/86 and 1986/87.

The facts are as follows:

1. The Taxpayer was incorporated in Hong Kong as a private company. At all material times, the Taxpayer was a registered investment adviser engaging in the management of customers' investment portfolios, which included the arrangement of purchases, sales and exchange of securities on behalf of customers through dealers and brokers, at agreed management fees.

2. The duties of the Taxpayer as an investment adviser were to advise the customers generally in relation to investments and, subject to any overriding instructions and overall policy directives which might be given to the Taxpayer by the customers, to manage and invest the funds placed by the customers with the Taxpayer as though the Taxpayer were the beneficial owner of such funds.

3. The duties of the Taxpayer included the acquisition and disposal of securities of every description, of foreign exchange currencies, of commodities and of all other kinds of investments. In this decision we refer to all of the foregoing types of investments simply as 'investments'.

4. In the performance of its duties, the Taxpayer was authorised and responsible for the appointment of agents and brokers to handle the acquisition and disposal of investments.

5. The remuneration of the Taxpayer comprised a management fee paid by the customers for the services of the Taxpayer, calculated as a percentage of the funds for the time being managed by the Taxpayer on behalf of the customers, such remuneration being payable periodically by deduction from the funds held by the Taxpayer for the customers. In addition, the Taxpayer was allowed by way of 'additional remuneration as manager' to receive and retain rebates and share commissions from stockbrokers employed by the Taxpayer to perform transactions carried out on behalf of the customers and comprising the acquisition of or disposal of any of the investments into which the funds of the customers entrusted to the Taxpayer were invested.

6. In the course of managing the funds of its customers the Taxpayer would give instructions for the acquisition or disposal of investments in Hong Kong and elsewhere in the world.

7. It was customary for the Taxpayer when effecting the acquisition or disposal of investments in markets outside of Hong Kong to negotiate for a share of the commission charged by the overseas agent for performing the transaction to be paid to the Taxpayer. For convenience, the amounts paid by the overseas agents to the Taxpayer are referred to in this decision as 'rebate commissions'.

8. In its profit and loss accounts for the years ended 31 December 1985 and 31 December 1986, the Taxpayer divided the rebate commissions received by it from both overseas and local agents as follows:

Year ended	Taxable	Foreign	Total
	$	$	$
31-12-1985	18,736,661	7,292,532	26,029,193
31-12-1986	33,177,580	9,398,183	42,575,763

9. The rebate commissions which are the subject matter of this appeal related to rebate commissions received for the purchase of overseas bonds and rebate commissions received for the purchase of overseas shares and securities. As the same principles apply to both types of rebate commissions, no distinction is drawn by this Board in this decision.

10. The entire operation, organisation, offices, staff and all other facilities of the Taxpayer were all situated in Hong Kong and nowhere else. The Taxpayer maintained bank accounts and securities accounts in foreign countries where it held investments belonging to its customers and was able to transfer moneys and give instructions to acquire and sell investments entirely at its discretion. All decisions and instructions were made in and given from Hong Kong. To effect transactions in the acquisition and disposal of overseas investments, the Taxpayer made use of the overseas services of agents in the form of brokers and others carrying on business in the countries and at the places where the overseas investments were traded. All instructions given to such overseas agents were given from Hong Kong being the only place where the Taxpayer had its staff and organisation.

11. The assessor did not accept the claim by the Taxpayer that the rebate commissions received from overseas agents constituted income which did not arise in and was not derived from Hong Kong and accordingly assessed the same to profits tax for the years of assessment 1985/86 and 1986/87. The Taxpayer duly lodged objections against the two assessments on the ground

that the commission received from the foreign brokers had an offshore source and accordingly should not be taxable in Hong Kong.

12. The Commissioner by his determination dated 18 October 1988 decided that the assessments had been correctly raised by the assessor and confirmed the same. The Taxpayer has duly appealed to this Board against the Commissioner's said determination.

At the hearing of the appeal, the Taxpayer was represented by Senior Counsel who submitted that the rebate commissions paid by overseas agents did not arise in nor were derived from Hong Kong. He took the Board through the leading cases on this subject matter and reviewed the evidence before the Board in the light thereof. Counsel for the Taxpayer referred the Board to the following cases:

Ogden Industries Pty Ltd v Lucas [1970] AC 113

Smidth v Greenwood [1921] 3 KB 583

Rhodesia Metals Ltd v Commissioner of Taxation [1940] AC 774

Commissioner of Income Taxes (NSW) v Hillsdon Watts 57 CLR 36

CIR v Hang Seng Bank Limited [1989] 2 HKLR 236

Commissioner of Taxation v Chunilal B Mehta [1938] All India Reports 521

CIR v The Hong Kong and Whampoa Dock Company Limited [1960] HKLR 166

CIR v International Wood Products Limited [1971] 1 HKTC 551

BR 18/73, IRBRD, vol 1, 118

CIR v Karsten Larssen & Co (HK) Ltd [1951] 1 HKTC 11

CIR v HK-TVB Inland Revenue Appeal No 9 of [1989]

Counsel for the Commissioner submitted that the rebate commissions were taxable in Hong Kong because they arose in or were derived from Hong Kong. She drew attention to the wording of the management agreement between the Taxpayer and one of its customers which was tabled as a sample of all such agreements and the provisions of which, so far as they are relevant, have been summarised in the facts set out above. She pointed out that the Taxpayer accepted that part of the remuneration paid to the Taxpayer for its services (that is, the percentage fee) was taxable in Hong Kong but was arguing that the other part of the fee payable under the same agreement (that is, the rebate commissions paid by overseas

brokers) was not taxable. She submitted that in accordance with the words of Lord Atkin in the Smidth v Greenwood case, the test to be applied in the present case was 'where did the operations take place from which the profits in substance arise?' Alternatively she said that it was necessary to identify the dominant factor of factors which gave rise to the profit.

Counsel for the Commissioner then went on to draw attention to the following facts which she said were the operations or dominant factors, namely:

1. The Taxpayer was incorporated in Hong Kong with its ultimate holding company being a public company in Hong Kong.

2. The Taxpayer was a registered investment adviser engaging in the management of customers' investment portfolios which included the arrangement of purchases, sales or exchange of securities on behalf of customers through dealers or brokers at agreed management fees.

3. The standard management agreement between the Taxpayer and its customers provided that the duties of the manager were to advise the customers generally in relation to investments and manage and apply the funds entrusted to the Taxpayer at the Taxpayer's discretion. The Taxpayer had full discretion to purchase and sell securities on behalf of its customers and instructions in respect of the purchases and sales were given by the Taxpayer to brokers by telephone from Hong Kong with subsequent confirmation by telex from Hong Kong.

4. The basis upon which the rebate commissions were computed was negotiated on a case by case basis with the overseas agents.

5. All decisions made by the Taxpayer regarding the management and operation of all of the portfolios of investments of its customers were made in Hong Kong by staff stationed in Hong Kong.

6. The management agreements between the Taxpayer and its customers were all governed by and construed in accordance with the laws of Hong Kong.

Counsel for the Commissioner then submitted that the rebate commissions were the entitlement of the Taxpayer by virtue of the provisions of the agreements between the Taxpayer and its customers and arose as a result of the Taxpayer exercising its discretion with regard to investment of funds. She submitted that these were the dominant factors which gave rise to the rebate commissions.

She then went on to distinguish the present appeal from the Chunilal B Mehta case by saying that the taxpayer in the Chunilal B Mehta case made a profit from the business of buying and selling commodities offshore direct. In the present appeal, the commissions earned were not earned from the actual trading on the stock markets overseas

but from rendering services under the investment agreement and in return the Taxpayer was given or allowed to keep the rebate commissions. She pointed out that the Taxpayer could never suffer losses as a result of trading on a foreign stock exchange.

This is a most interesting case and it is clear that whatever this Board decides may have wide reaching consequences in Hong Kong.

We preface our decision by drawing attention to the operations or dominant factors as submitted before us by the Counsel for the Commissioner. It appears to us that the stance of the Commissioner in Hong Kong has substantially changed in recent years with regard to what he considers is profit arising in or derived from Hong Kong. He appears to be very close to submitting that 'mind and management' or 'residence' as they are understood elsewhere in the world should be the tests for our territorial tax system. However, the Inland Revenue Ordinance has not been amended and it is therefore difficult to understand what is the justification for this apparent change in attitude. Furthermore we have no system of tax treaties to regulate the rights of competing tax commissions in different parts of the world.

Section 14 of the Inland Revenue Ordinance makes it quite clear that taxation in Hong Kong is based upon a territorial concept. Profits tax is only charged on persons who carry on a trade profession or business in Hong Kong (subject to certain statutory exceptions which have no application in this case). However, a person who carries on business in Hong Kong does not necessarily pay tax on all of his profits. He only pays profits tax on those profits which arise in or are derived from Hong Kong from the business which he carries on in Hong Kong. This makes it absolutely and totally clear that the mere fact of carrying on a business in Hong Kong does not make all of the profits of that business subject to tax.

The original leading case in Hong Kong is the Dock Company case. It has been cited and quoted so many times in the past that it is neither necessary nor appropriate for us to refer to the decision of Reece J in detail. The Dock Company case was a case involving the performance of services or operations which were substantially performed outside of Hong Kong. Reece J decided that under Hong Kong Revenue Law, it is not permissible to apportion income where part of the services are performed inside and part of the services performed outside of Hong Kong. He said that it was necessary to look at where the services were substantially provided and in the Dock Company case, this was outside of Hong Kong.

Though the Dock Company case is the first leading authority in Hong Kong on the geographic source of income, great care must be taken when making reference to it to make sure that one only refers to the legal principles and not to the application of those principles to the facts. The Dock Company case made clear statements of the law regarding 'operations'. However, this word has two clear and distinct meanings when used in relation to source in the Dock Company case itself. The Dock Company case related to the provision of services by the taxpayer, which services were largely provided outside of Hong Kong. The 'operations' to which reference is made in the Dock Company case were the work performed by a tug boat on the high seas and at the Paracel Islands in the South China Sea. Though arguments were put forward in that case that the maintaining of a tug boat

permanently in Hong Kong was the source of the profit, little or no reference was made in that case to the 'operations' of the dock company, namely, their being a Hong Kong company carrying on their business in Hong Kong and nowhere else, their maintaining an office in Hong Kong, their having staff and employees and accounts and other supporting services all in Hong Kong. Again there was some discussion as to the decision making process being in Hong Kong but only in relation to where the contract was made for performing the services. It was not suggested that the profit was taxable in Hong Kong because the board of directors and management of the dock company were situated in Hong Kong or that the decision making processes of the dock company were largely situated in Hong Kong. To summarise the 'operations' in the Dock Company case were the work done and not the support services and mind and management etc of the dock company itself. The 'operations' of the dock company itself were not considered by Reece J to be in any way material. The only 'operation' in Hong Kong was the physical towing of the salvaged vessel through Hong Kong territorial waters.

In the present case, we are dealing with rebate commissions paid by overseas agents to their principal in Hong Kong. The fact that the Taxpayer carried on its business in Hong Kong and nowhere else is not the determining factor in deciding whether or not profits from that business arise in or are derived from Hong Kong. If the mere fact of carrying on business in Hong Kong meant that all profits worldwide from such business were taxable in Hong Kong, then section 14 of the Inland Revenue Ordinance would be worded differently, Hong Kong would have a worldwide tax base and would require an extensive network of tax treaties. As we have already said, and for the sake of emphasis repeat again, tax is only charged on the assessable profits which arise in or are derived from Hong Kong from the trade profession or business which is carried on in Hong Kong. The words of section 14 are quite clear and precise and are capable of no other interpretation.

It is a well known legal maxim that hard facts lead to bad law. Recently there have been a number of sets of facts which has come before Boards of Review and our courts which perhaps fall into this category of hard facts. Whilst the legal decisions which have been made based on those facts are not necessarily bad in themselves, they become bad if one tries to apply them to other sets of facts. No rules based on factual circumstances can be derived from tax cases. Every case must be decided on its own particular and peculiar facts according to the clear and strict wording of the Inland Revenue Ordinance.

One principle which appears from all the decided cases is that each case must be decided on the totality of its facts and that no short cuts can be taken in categorising sets of facts or laying down guidelines for different categories of cases. The question of geographic source of income for tax purposes is a practical hard matter of fact as laid down by Lord Atkin.

It was also Lord Atkin who laid down the so-called 'operations' tax when he said in Smidth v Greenwood:

> ' I think that the question is, where do the operations take place from which the profits in substance arise?'

Lord Atkin also in the same case said that source is not a legal concept but something which a practical man would regard as a real source of income.

In this case we could cite extensively from the leading cases on source in Hong Kong and elsewhere but we consider it unnecessary and inappropriate to do so as we have said each case must be decided on its own peculiar facts. However this does not mean that decided cases can be or have been ignored by this Board and we are much indebted to Counsel for bringing relevant cases to our attention in the course of the hearing.

The question which we now ask ourselves is where did the operations take place from which the profits in substance arise in this present case.

The Taxpayer carried on its business in Hong Kong and nowhere else. In normal circumstances, profits arise where a person carries on its business. However, as we have said this is not necessarily the determining factor. In this appeal, the Taxpayer claims otherwise and with due respect to the submissions made by Counsel for the Commissioner, on the totality of the facts before us we find in favour of the Taxpayer.

The nature of the income is a share of commissions earned by overseas brokers. What the Taxpayer was receiving was an actual share of the overseas agents commission. Clearly the overseas agent earned its commission overseas. It cannot be suggested for one moment that the overseas agent is taxable in Hong Kong on the fees which it earned. The agreements between the Taxpayer and its overseas agents were to share in the gross profits, that is, commissions which the overseas agents made on business offered to the overseas agents by the Taxpayer.

We have given deep thought to the question of whether or not it can be said that the rebate commissions arose from the management contract between the Taxpayer and its customers and are therefore sourced in Hong Kong. This is an attractive argument because there is no doubt that the principal fees earned by the Taxpayer under its management contracts are taxable in Hong Kong and comprise a percentage of the funds under management. However, in our opinion, this is placing too much importance on the management contract as the source and is introducing an element of artificiality into the matter.

We have also given careful thought to the nature of the remuneration. The remuneration is stated in the management contracts to be remuneration for the management services of the Taxpayer which services were performed in Hong Kong. However, though there is some logic in this argument, it comes very close to saying that because the Taxpayer is carrying on business in Hong Kong, therefore, all of his income must be taxable in Hong Kong. We have clearly renounced this as being an applicable principle in Hong Kong and think that we must look more closely at the nature of the income in this particular case. The

operations from which this particular income arose were the activities of overseas agents buying and selling investments in their own overseas market places. To find that such income originates in Hong Kong would be flying in the face of what a practical man would regard as the real source of the income in this case.

We have also looked at all of the other facts and particularly those emphasised by Counsel for the Commissioner. For example she urged us to look at the place where the Taxpayer was incorporated and the fact that its ultimate holding company was a Hong Kong public company. We ask ourselves in what way this affects the source of the commissions. The answer must be very little, if any at all.

For the foregoing reasons and based on the facts before us, we find as a matter of fact that the rebate commissions which are the subject matter of this appeal did not arise in nor were derived from Hong Kong and accordingly should not be charged to Hong Kong tax.

We direct that the assessments appealed against be referred back to the Commissioner to be reduced accordingly. In the event of the Commissioner and the Taxpayer being unable to reach agreement as to the necessary reductions and apportionment of expenses, liberty is granted to the parties to refer the matter back to the Board of Review for determination.